No. 83-832

# In the Supreme Court

OF THE

# United States

OCTOBER TERM, 1984

HAROLD T. PAULSEN, ET UX.,
*Petitioners,*

vs.

COMMISSIONER OF INTERNAL REVENUE

**On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit**

## REPLY BRIEF FOR THE PETITIONERS

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## QUESTION PRESENTED

Whether the merger of a state stock-type savings and loan association into a federal mutual savings and loan association, in which all the stock of the state association is exchanged for ownership savings accounts representing share interests in the federal mutual association, qualifies as a reorganization upon which taxable gain is deferred under sections 368(a)(1)(A) and 354(a)(1) of the Internal Revenue Code of 1954, as amended (the "Code").

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## ARGUMENT.

Respondent's only argument in his brief appears to be that this merger *should* be currently taxed because, in respondent's view, petitioners and the other former shareholders of Commerce could easily liquidate the proprietary interest they received through the merger of Commerce into Citizens Federal. That is not the law; nor has respondent cited any authority which supports such a proposition.[1] If liquidity were the test, many reorganizations never questioned by respondent would be disqualified by the marketability, or redeemability, of the stock received by the acquired entity's shareholders.

## I

## RESPONDENT HAS FAILED TO ADDUCE ANY STATUTORY OR JUDICIAL AUTHORITY WHICH SUPPORTS HIS CONTENTION THAT THE MERGER AT ISSUE WAS NOT A REORGANIZATION.

### A. Respondent's Interpretation of the Continuity of Proprietary Interest Requirement Has No Basis in the Law.

To reach the result he desires in this case, respondent urges upon the Court a radical departure from the well-accepted meaning and proper application of the "continuity

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[1]That the perceived liquidity of petitioners' investment is the core of respondent's argument is illustrated by respondent's own terminology. While never actually calling the accounts "debt," because as even respondent concedes, they clearly do represent a proprietary stake in Citizens, respondent resorts to terms such as "cash *equivalent*" (Resp. Br. 17), "*functionally equivalent*" to debt (Resp. Br. 17), "*substantially identical*" to debt (Resp. Br. 17), "*essentially the equivalent* of cash" (Resp. Br. 26), "*essentially* bank deposits" (Resp. Br. 26), "*resembling* bank deposits" (Resp. Br. 29), "*essentially cashed* their investment out" (Resp. Br. 35), "non-equity *features*" (Resp. Br. 38, 41), "*hybrid* interest" (Resp. Br. 37), "*strong flavor of* cash equivalency" (Resp. Br. 38), "debt *features*" (Resp. Br. 9). For the first time, respondent also adopts the label "dollar obligations" to refer to petitioners' investment in Citizens, a term which has no legal meaning of which we are aware.

of proprietary interest" requirement. As this Court has held, and respondent concedes (Resp. Br. 35, n. 27), the test for continuity of proprietary interest is not whether "the relationship of the [exchanging shareholders] to the assets conveyed [has] substantially changed." *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 386 (1935). Rather, the focus must be on the *nature* of the interest received.

In a footnote, respondent denies that "the decision below . . . and the Commissioner's position . . . mak[e] satisfaction of the 'continuity of interest' requirement turn, erroneously, on 'the perceived degree of change in the proprietary interest received,' rather than on 'the nature of the interest received'" (Resp. Br. 35, n. 27). Respondent's denial, however, is undercut by his failure to explain how the test can be satisfied when a share account in a mutual savings and loan association is exchanged for a share account in another mutual asociation, but *not* when the same interest is received in exchange for stock in a stock savings and loan association. *Compare* Rev. Rul. 69-3, 1969-1 C.B. 103 *with* Rev. Rule 69-6, 1969-1 C.B. 104. Indeed, respondent's explanation of his ruling position makes it clear that he *is* relying "on 'the perceived degree of change in the proprietary interest received,' rather than on 'the nature of the interest received'" (Resp. Br. 35, n. 27). He states that "[w]hen two mutual associations merge . . . the [exchanging account holders'] proprietary interests . . . *continue without alteration*," and that [w]hen a mutual association merges into a stock association, the [exchanging account holders'] . . . proprietary interests continue (*indeed, are enhanced*) . . ." (Resp. Br. 44) (emphasis added). On the other hand, he contends that when a stock association merges into a mutual association, receipt of the *same* proprietary interest by the exchanging account holders constitutes a "liquidat[ion of] their equity investment. . . ." *Id.* (emphasis added).



In an obvious effort to avoid the holding in *Minnesota Tea* and to divert attention from the erroneous standard the court of appeals below applied to this transaction, respondent offers yet another interpretation of the continuity of proprietary interest requirement. Quoting out of context only a portion of the language used by this Court in *Minnesota Tea*, respondent argues that '[t]he equity stake petitioners acquired in Citizens did not 'represent a substantial part of the value' [the Court's language] *of what they got in the merger* [respondent's language]" (Resp. Br. 9) (emphasis added). From that premise, respondent concludes that the continuity of proprietary interest requirement has not been satisfied because "[u]nder this Court's cases, it is not merely the *existence* of equity features, but their *materiality* and *substantiality*, that determine whether a merger is a 'reorganization' or a 'sale'" (Resp. Br. 34) (emphasis in original).

The language of *Minnesota Tea* from which respondent quotes reads:

> And we now add that this interest [in the affairs of the acquiring company] must be definite and material; it must represent a substantial part of the value *of thing transferred*. This much is necessary in order that the result accomplished may genuinely partake of the nature of merger or consolidation.

296 U.S. at 385 (emphasis added).[2] On the next page of the Court's opinion, Mr. Justice McReynolds repeats that "so long as the taxpayer received an interest in the affairs of the transferee [corporation] which represented a material part of the value *of the transferred assets*," the continuity of proprietary interest requirement would be satisfied. *Id.* at 386 (emphasis added).

[2] The exchanging shareholders in *Minnesota Tea* received voting trust certificates representing common stock in the transferee corporation worth approximately $540,000 and, in addition, cash in the amount of $425,000. 296 U.S. at 384.

Respondent's adaptation of the Court's language to suit his argument is incorrect. Contrary to respondent's assertion, the Court did ***not*** espouse the fragmentation and valuation of the "equity features" and "non-equity features" of the consideration received which represented an "interest in the affairs of the transferee" corporation. Nor did the Court state that the "equity features" must reflect a "substantial part" of the value of the proprietary interest *received*. Instead, the Court stated that a *material portion* of the stock or assets *exchanged must be exchanged* for consideration which confers a continuing proprietary interest in the transferee corporation upon the exchanging shareholders. In *Minnesota Tea*, those shareholders received cash, a separate form of consideration, *in addition to* stock representing a proprietary interest in the transferee. The Court was therefore concerned with the effect of the cash consideration which represented no continuing proprietary interest in the business enterprise. Where, as here, only *one* type of consideration is received by the exchanging shareholders for *all* of their stock, and that type of consideration is the only form of equity capital issued by the transferee, the continuity of proprietary interest requirement is satisfied. No court, until the Ninth Circuit below, has ever held otherwise.

Respondent's misstatement of the principle enunciated in *Minnesota Tea* is a disguised attempt to apply the very standard which he concedes is erroneous under this Court's decisions (*See* Resp. Br. 35, n. 27). Under a slightly different cover, respondent is still arguing that the relationship of the taxpayer to the assets transferred, which relationship is defined by the terms of the proprietary interest received, must continue substantially unchanged. Otherwise, the position he takes in his published rulings is inconsistent with his new analysis.



If, as respondent contends, the continuity of proprietary interest test is satisfied only when the "equity features" of the consideration received " 'represent a substantial part of [the consideration's] value' " (Resp. Br. 9), and if the "equity features" of a share account in a mutual savings and loan association do not meet that test, then respondent's published ruling that a merger of two mutual savings and loan associations is a reorganization must be wrong. There, the consideration received by the exchanging shareholders is the *same* consideration received by the petitioners here. *See* Rev. Rul. 69-3, 1969-1 C.B. 103. Its "equity features" therefore have the same "value" compared to what respondent considers to be its "non-equity features." Consequently, if the test is not satisfied here because those "equity features" lack sufficient "value," it also cannot be satisfied in the case of a mutual-into-mutual merger.

To our knowledge, respondent has never refused reorganization treatment to mergers of mutual associations into mutual associations. If his new version of the continuity of proprietary interest requirement is correct, however, it follows that all of those mergers are taxable sales of assets on which the acquired associations are required to recapture bad debt reserves, depreciation, investment tax credit and tax benefit items as ordinary income, as well as recognize any gain or loss on the sale of the assets. Respondent's new test would thus discriminate against all federal savings and loan associations organized in mutual form by denying them the ability to reorganize without incurring a substantial tax except when acquired by a stock association. Congress could not have intended such a result.[3]

[3]Respondent points out that Congress was aware in the late 1960's that restoration of bad debt reserves into income by acquired savings and loan associations would be necessary in the case of sales, *but not reorganizations*, of those associations. (Resp. Br. 45 & n. 33). Respondent's suggestion, however, that this supports his position

Finally, despite respondent's repeated assertions to the contrary (Resp. Br. 10, 41), petitioners have never "stipulated" to the value of what respondent calls "nonequity features." Nor is respondent's inability to value the "equity features" of petitioners' accounts the fault of the "record in this case," on which respondent lays the blame (Resp. Br. 41). It derives, instead, from the circularity of respondent's argument. Once he determines that the "value" of the so-called "non-equity features" of petitioners' accounts is defined by the amount that petitioners might realize if they liquidated their investment, nothing can, by definition, be left to allocate to the "equity features." Indeed, petitioners would necessarily lose, and have no further reason to be interested in, those "equity features" upon the disposition of their accounts. The same is true when any share of stock is redeemed or sold. Under respondent's reasoning, the amount that could be realized upon disposition of the stock would be the value of its "non-equity features." His theory would therefore assign no value to the "equity features" of a share of stock in any corporation, and petitioners are in no different position than would be any other stockholder subjected to his analysis.[4]

will not withstand scrutiny. The only published case law in existence at that time addressing whether a transaction such as the one at issue constituted a nontaxable reorganization was *Estate of W. T. Hales v. Commissioner*, 40 B.T.A. 1245 (1939). In that case, respondent conceded that the transaction was a reorganization. Furthermore, respondent's implication that Congress was somehow omnisciently approving in advance the Ninth Circuit's 1975 decision in *Home Savings & Loan Ass'n v. United States*, 514 F.2d 1199 (9th Cir.), *cert. denied*, 423 U.S. 1015 (1975) is not only absurd, it is irrelevant to this case. *Home Savings* did not involve mutual savings and loan associations. It dealt solely with stock associations in which all of the stockholders had sold their stock for cash prior to the merger.

[4]This is no doubt why, "in litigated cases, classification has been treated as an all-or-nothing question, so that instruments have not been fragmented into part equity and part debt." B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 4.01, at 4-7 (4th ed. 1979). *See also*, *Monon Railroad v. Commissioner*, 55 T.C. 345, 356 (1970).



**B. The Code Sections Upon Which Respondent Relies Have No Bearing on the Reorganization Provisions in Issue Here.**

Respondent seeks support for his position from two Code sections which were enacted (i) to provide a specific tax deduction to mutual savings and loan associations that would otherwise not have been available, because they do not pay "interest" to their account holders (section 591); and (ii) to specify the proper use and taxation of reserves for losses on loans (section 593). From the enactment of these two sections, respondent concludes that "[t]he evolution of the relevant Code provisions reveals a deliberate Congressional intent increasingly to assimilate [mutual savings and loan associations] and their members to banks and their depositors" (Resp. Br. 18). He then argues that mutual savings and loan associations should therefore be denied the benefit of the reorganization provisions available to those same banks!

In his fervor to corroborate his assertion that sections 591 and 593 are relevant, respondent first mischaracterizes the impact of section 591. He then suggests, erroneously, that the provisions of section 593(e) (formerly, section 593(f)) governing distributions of "property" to "shareholders with respect to their stock" do not apply to mutual savings and loan associations (Resp. Br. 22-23 & n. 17). From this respondent concludes that other Code provisions dealing with distributions of property by corporations, such as section 302 (redemptions), section 331 (liquidations) and section 346 (formerly, partial liquidations, now containing certain special rules and definitions), do not apply to distributions by *mutual* savings and loan associations. *Id.* Respondent is wrong on both counts.

The predecessor to section 591 of the Code, as first enacted in 1951, allowed mutual savings and loan associations (included within the term "domestic building and loan associations"), together with certain other financial institutions, a deduction for "amounts paid ... or credited ... as dividends on ... deposits or withdrawable accounts. . . ." Revenue Act of 1951, ch. 521, § 313(f), 65 Stat. 491, amending 1939 Code § 23(r), 53 Stat. 16. In the Revenue Act of 1962, Pub. L. No. 87-834, § 6(f), 76 Stat. 984, section 591 was amended to add the words "or interest," reflecting the general liberalization of language beginning to be used by the institutions and the public at the time, but not in response to any change in the legal rights of accounts or account holders receiving the distributions. *See Midwest Savings Ass'n v. Commissioner*, 75 T.C. 262 (1980) (discussing in detail the legislative history surrounding the enactment of and the 1962 amendment to section 591).[5]

The deduction allowed under section 591 is not applicable to true interest payments. The interest paid by banks and by stock savings and loan associations on their deposits is deductible under section 163 of the Code, when paid *or accrued. See id.* at 266-67 (quoting *Hudson City Savings Bank v. Commissioner*, 53 T.C. 70, 74-75 (1969)). On the other hand, distributions deductible under section 591 must be at the complete disposal of the account holder, "withdrawable on demand," before the association will be allowed a deduction. I.R.C. § 591(a). Dividend distributions made by mutual savings and loan associations, whether interest-like or not, are deductible under section 591. *Midwest Savings*

[5]It is not unusual for Congress to grant special deductions for dividends paid on stock. *See, e.g.,* former section 583 of the Code (repealed effective for taxable years beginning after December 31, 1976), providing a deduction for dividends paid by banks, trust companies and incorporated domestic insurance companies on their "preferred stock" owned by the United States or any instrumentality thereof exempt from federal income taxes.



*Ass'n*, 75 T.C. at 269.[6]

Section 593(e)(1) of the Code, to which respondent refers, states, in relevant part:

> For purposes of this chapter [normal taxes and surtaxes, including all corporate tax provisions], any distribution of property (as defined in section 317(a)) by a *domestic building and loan association . . . to a shareholder with respect to its stock, if such distribution is not allowable as a deduction under section 591, shall be treated as made —*
>
> (A) . . . [first out of post-1951 earnings and profits, and then out of certain bad debt reserves and other accounts] . . .
>
> . . . .
>
> This paragraph shall apply in the case of any distribution in redemption of stock or in partial or complete liquidation of the association . . . [except that the order of funds from which these distributions are deemed made is altered]. This paragraph shall not apply to any transaction to which section 381 (relating to carryovers in certain corporate acquisitions) applies. . . .

[6]*Midwest Savings* illustrates the type of ownership rights which respondent would deny exist in Citizens Federal account holders. There, two mutual savings and loan associations agreed to merge. Pursuant to the merger agreement, exchanging account holders were offered a choice of one of three options, each assuring them a 4 percent bonus over and above the withdrawal values of their accounts as of a certain date. 75 T.C. at 264-65. Thus, each exchanging account holder was entitled to receive an amount that was presumably equal to the excess value of his pro rata interest in his association's net assets over the value of the interest he would receive in the acquiring association's assets if that interest were based on the withdrawal value of his account. The account holders' elected board of directors who negotiated the merger took full advantage of the account holders' ownership rights. Yet the court of appeals below gave those same legal rights "no weight" in its decision in this case (Pet. App. 28).

From the face of the statute, it is obvious that section 593(e) applies (i) to all domestic building and loan associations, including those organized in mutual form,[7] (ii) to all distributions of property[8] to a shareholder of such an association *with respect to its stock, unless the distribution is deductible under section 591*; and (iii) treats withdrawable share accounts and deposits as stock and the holders of those accounts as shareholders, since there would be no other reason for section 593(e) to exclude distributions deductible under section 591.

Distributions which are not deductible under section 591, but are instead within section 593 and are therefore subject both to section 593 and to the normal Code provisions governing distributions to corporate shareholders (Resp. Br. 22), include distributions in redemption of the account or in partial or complete liquidation of the association. *See* Rev. Rul. 57-39, 1957-1 C.B. 198 ("[U]ndistributed earnings of a domestic building and loan association distributed in complete liquidation to the holders of withdrawable shares in the association are *not deductible* by the association as dividends paid within the meaning of section 591 of the Internal Revenue Code of 1954, in computing its taxable income for the year of liquidation.") (emphasis added). If those distributions are considered to be made out of the bad debt reserves described in section 593(e)(B) or (C), section 593(e)(2) (Reply Br. App. 2) requires that they be recaptured into income. On liquidation, for example, a mutual savings and loan association would be required to recapture its unused bad debt reserves under section 593,

[7]Federal mutual savings and loan associations are generally "domestic building and loan associations" entitled to employ the bad debt reserve rules of section 593. *See* I.R.C. § 7701(a)(19) (Resp. Br. App. 6a-9a).

[8]The term "property" is defined by Code section 317(a) to include money. I.R.C. § 317(a).



as well as investment tax credit and depreciation under other Code sections in the same manner as would any other corporation. Respondent's reliance on this line of argument to support his case is therefore badly misplaced.

### C. The 1968 Amendment to Section 5(b) of the Home Owners' Loan Act of 1933 Did Not Change the Capital Structure of Federal Mutual Savings and Loan Associations or the Ownership Rights of Their Account Holders.

Respondent charges that "[i]n 1968, . . . Congress decided that the formal capital structure of federal savings and loans should be brought more nearly into conformity with the public view of those institutions" (Resp. Br. 24). He implies that the 1968 amendment to section 5(b) of the Home Owners' Loan Act of 1933, 48 Stat. 132, 12 U.S.C. § 1464(b) (the "1968 amendment"),[9] altered the capital structure of those institutions and therefore converted their account holders into bank depositors and their accounts into debt. But Congress made no such change. The change made was one in authorized *terminology*, and the legal rights of account holders in federal associations continue to be defined by the charters of those associations and the federal regulations governing them. 12 U.S.C. § 1464(b)(1) (1976 ed.) (Resp. Br. App. 10a-11a). *See* H.R. Rep. No. 1585, 9th Cong., 2d Sess. 107 & 152 (1968) (stating that the amendment was intended to "allow *the use of such terms as* 'savings deposits' with reference to accounts in Federal savings and loan associations," and that the section authorizing use of the new terminology "does not represent any radical innovations in our financial systems . . . .") (emphasis added).

[9]Housing and Urban Development Act of 1968, Pub. L. No. 90-448, § 1716(a), 82 Stat. 608.

The 1968 amendment came about in the following manner. In 1949, the regulations prescribing charters for federal mutual savings and loan associations began to use the term "savings account" to describe a member's share interest in the association, because that term was in common public usage and because of pressure from savings and loan groups to be allowed to use the same terminology as banks, despite the legal differences in their accounts.[10]

In 1958, a group of bankers challenged the regulations allowing mutual savings and loan shares to be called "savings accounts" as "unauthorized" and "illegal" under section 5(b) of the Home Owners' Loan Act, which, they argued, only authorized the associations to raise capital by payments on "shares." *Wisconsin Bankers' Ass'n v. Robertson*, 294 F.2d 714 (D.C. Cir.), *cert. denied*, 368 U.S. 938 (1961), *reh'g denied*, 368 U.S. 979 (1962). The bankers contended that the provision in the regulations allowing federal savings and loan associations to raise capital by payments on "savings accounts" instead of on "shares" as the statute required converted an account holder to a "creditor of the association just as a holder of a savings account in a bank is a creditor of the bank." *Id.* at 716.

The court of appeals, looking beyond the formal terminology to the substantive legal rights of the account holders and to the definition of a "savings account" as the holder's interest in the capital of the association, rejected the bankers' claim. It found that the accounts, despite what they were called, had "the same meaning as the word 'shares' in the statutory provision governing the raising of capital." *Id.* at 716. Judge (now Chief Justice) Burger explained more fully in his concurring opinion:

[10]Later, the term "deposit" came to be used by the public in much the same manner.



> The capital of a federal savings and loan association *is* raised by payments on share interests. Calling them "payments" on "savings accounts" does *not alter their legal status*. That the payment may be regarded . . . as a "deposit" or even called at times a deposit by the association does not make it a legal counterpart of a deposit in a bank. The "depositor" in a federal association is not a creditor as is a depositor in a bank.

*Id.* at 717 (emphasis added).

The 1968 amendment upon which respondent places such emphasis was enacted to put an end to the disputes between banking groups and savings and loan groups over the use of terminology such as "savings accounts" and "deposits," and was a direct outgrowth of the decision in *Wisconsin Bankers*. Congress responded by making it clear that federal savings and loan associations could use the same terminology as banks. That is, they could

> raise [their] *capital* in the form of such saving deposits, shares or other accounts, . . . (all of which are referred to in this section as savings accounts and all of which shall have the same priority upon liquidation) *as are authorized by* [*their*] *charter* or by regulations . . . and may issue such passbooks, time certificates of deposit, *or other evidence of savings accounts* as are so authorized.

12 U.S.C. § 1464(b) (1976 ed.) (Resp. Br. App. 10a-11a).

Like the regulations objected to in *Wisconsin Bankers*, the 1968 amendment did not change the capital structure of federal mutual associations. The language of the statute clearly states that the legal rights of account holders, whether denominated "savings account holders" or "depositors," are governed by the association's charter, and petitioners' accounts are defined in the regulations just as they were at the time of *Wisconsin Bankers* as "the monetary

interest of the holder thereof in the capital of a Federal mutual association. . . ." 12 C.F.R. § 541.4 (1976 ed.) (Reply Br. App. 1); *see also* 12 C.F.R. § 541-3 (1976 ed.) (Reply Br. App. 1). This case turns on the same debt-versus-equity characterization which was key to resolution of the issue in *Wisconsin Bankers*. The 1968 amendment to section 5(b) is therefore irrelevant to the Court's decision.

## II

## THE SAME FACTORS WHICH LED THIS COURT TO CHARACTERIZE THE ACCOUNTS IN TCHEREPNIN V. KNIGHT AS STOCK ARE CONTROLLING IN THIS CASE.

Respondent endeavors to minimize the importance of this Court's holding in *Tcherepnin v. Knight*, 389 U.S. 332 (1967), by dismissing it as simply a case construing another statute which "turned upon the language and purposes of the particular statute[] under which [it] arose" (Resp. Br. 18). But respondent misses the point. The "narrow question for decision in [*Tcherepnin* was] whether a withdrawable capital share in [a state mutual] savings and loan association [was] a 'security' within the meaning of the Securities Exchange Act of 1934. . . ." *Id.* at 332. Nevertheless, the Court found it necessary to "look first to the legal character imparted to those shares by [the governing] statute" to determine whether they were within any of the listed categories of instruments designated as "securities" by section 3(a)(10) of the 1934 Act, and therefore qualified their holders as "investors" entitled to its protection. *Id.* at 336.

The "legal character" of the accounts at issue in *Tcherepnin* was substantially identical to the "legal character" of the Citizens Federal accounts received by petitioners in this case. The accounts there represented shares in the capital of the association. They entitled their holders to vote, they



did *not* entitle their holders to a fixed rate of return, but rather to dividends declared by the board of directors and which were contingent upon profits, they were withdrawable, but only under certain specified conditions, as are petitioners' accounts[11] and holders did not become creditors of the association when they filed applications for withdrawal. Finally, the accounts represented all the equity capital in the association. *Id.* at pp. 337-340, 344. The Court found that "[t]hese same factors make the shares "stock" under § 3(a)(10)." *Id.* at 339.

The term "stock" is not defined in the Securities Exchange Act, as it is in the Code, to include "shares in an association." Yet the Court, even without such guidance, found that "form should be disregarded for substance and the emphasis should be on economic reality" (*Id.* at 336). Based on that principal, which applies with equal force in the tax law, the Court determined that the substance and economic reality of accounts such as those at issue here made them "stock." In so holding, the Court flatly rejected the conclusion of the Court of Appeals for the Seventh Circuit that the account holders' " 'relationship with the enterprise

[11]Respondent persists in labelling Citizens Federal's accounts "demand deposits." Not only do petitioners' legal rights with respect to the accounts bely such a characterization, but in 1976, federal mutual savings and loan associations were *prohibited* from issuing any "demand deposits." *See* H.R. Rep. No. 1585, 90th Cong. 2d Sess. 152 (1968) ("Demand deposits are prohibited.") Respondent also mistates the facts (as did the Ninth Circuit in its opinion) as to Citizens Federal's right to redeem its accounts (Resp. Br. 3). If Citizens were to call any of its accounts, it would be *required by law* to pay "the full value thereof, as determined by the board of directors," which would certainly *include* the account holder's pro rata interest in Citizens' assets (J.A. 42). "In practice," Citizens Federal has never called any accounts for redemption and would, obviously, be subject to the securities laws if it did so unfairly. *Tcherepnin v. Knight*, 389 U.S. 332 (1967).

is much more that of debtor-creditor than investment.'" *Id.* at 344. On the other hand, bank deposits, precisely because they *do* represent a debtor-creditor relationship, and *not* an investment in the enterprise, have been held by this Court *not* to constitute "securities" within the meaning of the Securities Exchange Act. *Marine Bank v. Weaver,* 455 U.S. 551, 557 (1982) (Burger, C.J.) (distinguishing *Tcherepnin* because "[i]n short, the withdrawable capital shares in *Tcherepnin* were much more like ordinary shares of stock and 'the ordinary concept of a security' . . . than a certificate of deposit [in a bank]."[12]

## III

## RESPONDENT'S "ALTERNATIVE" ARGUMENT IS AN ASSERTION THAT A REORGANIZATION CAN OCCUR WITHOUT CONTINUITY OF PROPRIETARY INTEREST.

Respondent contends, in the alternative, that if a reorganization took place, petitioners' exchange should still be taxed as property other than stock under section 356 of the Code (Resp. Br. 36 *et seq.*). Yet in his response to our Petition for Certiorari in this case, respondent conceded that "[p]arallel consequences for the corporation and its

[12]In *Porter v. Aetna Casualty and Surety Co.*, 370 U.S. 159 (1962), this Court also recognized that, "[u]nder the law the depositor [in a federal mutual savings and loan association] is a shareholder rather than a creditor. . . ." *Id.* at 161. As Mr. Justice Douglas stated in his separate opinion, "[t]he owner of a share account is a voting member of the association which, as the Court of Appeals noted, makes him 'more nearly comparable to a stockholder of a bank than one of its depositors'." *Id.* at 163. The issue before the Court in *Society of Savings v. Bowers*, 349 U.S. 143 (1955), on which the court of appeals below relied, did not turn on the "legal character" of accounts in mutual savings and loan associations. The Court there was concerned only with whether an Ohio state tax was, in reality, being imposed on two "mutual savings banks," or on their depositors. *Id.* at 148.



shareholders flow automatically from [the] determination" of "whether the merger was a tax-free 'reorganization'" (Resp. Pet. Br. 7, n. 2). Respondent further conceded that the court of appeals decision below therefore "squarely conflicts with the decisions of the Court of Claims in *Capital Savings & Loan*, . . . the Sixth Circuit in *West Side Federal Savings & Loan*, . . . and the Tenth Circuit in *Everett*. . . ." (*Id.* at 7), which each found a comparable merger to be a reorganization at the corporate level. Similarly, in his brief to the Court of Claims in *Capital Savings & Loan Ass'n v. United States*, 607 F.2d 970 (Ct. Cl. 1979), he contended:

> [Capital Savings & Loan Association's] suggestion . . . that the proper characterization of its merger as a reorganization might differ vis-a-vis Franklin's guaranty stockholders from what that characterization should be from its standpoint is *plain nonsense.* All aspects of the merger transaction must be evaluated and then the transaction as a whole will or will not qualify as a reorganization.

Reply Brief For the United States In Support Of Its Motion For Summary Judgment In *Capital Savings & Loan Ass'n v. United States,* at 10, n.4 (Reply Br. App. 1). The Court of Claims agreed, stating:

> We are aware that one of the ramifications of our decision is that Franklin stockholders will not have their gain, if any, recognized until they withdraw sums from their Capital accounts. . . .

607 F.2d. at 977.

Now embracing what he proclaimed to be "plain nonsense," respondent states that "[e]ven if [the Citizens Federal accounts] are imbued with sufficient equity characteristics to satisfy the 'continuity of proprietary interest' test, and thus enable the overall transaction to qualify as a

'reorganization,' . . . petitioners . . . must recognize gain [on their exchange] . . . ." (Resp. Br. 37).

It is well-settled that only stock will satisfy the continuity of proprietary interest requirement, without which there cannot be a reorganization. *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933) (receipt of cash and short term promissory notes); *Le Tulle v. Scofield*, 308 U.S. 415, *reh'g denied*, 309 U.S. 694 (1940) (receipt of debt securities). If the sole consideration received by the exchanging shareholders is debt, cash or other property, the transaction is nothing more than a sale, and does not "partake of the nature of a [reorganization]." 296 U.S. at 385. Moreover, as this Court instructed in *Minnesota Tea*, 296 U.S. 378, the qualifying consideration (stock) received by the exchanging shareholders must "represent a substantial part of the value of the [assets] transferred." *Id.* at 385.

Ignoring this established line of authority in his "alternative argument," respondent urges this Court to find that if there was a reorganization, petitioners and the other former Commerce stockholders must nonetheless be taxed as if they had already liquidated their accounts, or, to put it another way, as if they had received no proprietary interest in Citizens Federal in the merger.[13] If that were the case, the transaction *would* be nothing more than a sale for *all concerned*. Respondent is therefore contending that there can be a reorganization without any continuing proprietary interest on the part of the exchanging shareholders. He acknowledges this when he confesses that his "reasoning also suggests that the value of the 'equity components' of petitioners' savings accounts is close to zero,"

[13]Obviously, petitioners, no more than any other shareholder, can both dispose of their shares and also retain their ownership rights in Citizens.



and adds that it "merely goes to show that [his] primary submission is correct" (Resp. Br. 41-42). In substance, then, respondent's alternative position, for which he cites no precedent, would require that the Court overrule *Pinellas*, *Le Tulle v. Scofield* and *Minnesota Tea*, and thus upset fifty years of tax jurisprudence.

## IV

## RESPONDENT'S SO-CALLED "SERIOUS PRACTICAL AND ADMINISTRATIVE PROBLEMS" ARE THE SAME HERE AS WITH ANY REORGANIZATION.

Respondent again raises the specter of collection difficulties unless mergers such as this are denied reorganization treatment. Aside from being irrelevant to whether the merger at issue was a reorganization, the collection difficulty described by respondent is present in any reorganization. Because gain is deferred on the transaction, the exchanging shareholders retain their old basis and thus recognize the full amount of the deferred gain, if any, when they liquidate the investment and have the money to pay the tax.

The substituted basis flowing from reorganization treatment is no more of a practical problem in this case than in any other. More often than not, exchanging shareholders receive a different number of shares, or a different kind of shares, of stock than they surrender. Basis must, therefore, always be apportioned and traced so that gain can be properly reported when the stock is redeemed or sold.

As we noted in our Opening Brief, in all of the mergers of this type we have seen, the accounts received by the exchanging shareholders have been segregated and the passbooks or certificates stamped to reflect that they represented exchange accounts. No additional sums are invested in the exchange accounts. If the owners wish to increase their investment in the association, they are free to open another, separate account. Thus, respondent's assertion

that "[e]very time petitioners deposited money into their passbook savings accounts, they would have to keep the 'new cash' . . . separate from the 'old cash' . . ." (Resp. Br. 42) is simply a red herring. Nor are withdrawals a problem. Basis is easily allocated to the portion withdrawn and gain reported on the difference between the allocated basis and the amount of cash received.[14]

Finally, respondent claims, on the one hand, that if petitioners' accounts are "stock," section 302 of the Code would require that each redemption be tested to determine whether it was "essentially equivalent to a dividend," and on the other hand, that section 302 does not apply (Resp. Br. 22-23, 43). Petitioners reiterate that section 302 *does* apply to shareholders in mutual savings and loan associations, but because withdrawals are normally non-pro rata and sporadic, they are not "essentially equivalent to a dividend" and therefore are treated as "exchanges" under section 302(b)(1) (Pet. Br. 41).

## V

## CONCLUSION

The judgment of the court of appeals should be reversed.

Dated: October 19, 1984.

Respectfully submitted,

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[14]Respondent's allusion to "checking accounts" (Resp. Br. 43) which federal associations have been allowed to offer since Congress passed new legislation in 1982 is inapposite. That was not the law at the time of this merger, and petitioners' share accounts are not checking accounts. *See* Thrift Institutions Restructuring Act of 1982, Pub. L. No. 97-320, § 301, 96 Stat. 1469.

## APPENDIX.

**12 C.F.R. § 541.3 (1976 ed.):**

§ 541.3 Capital.

The term "capital" means in a Federal mutual association the aggregate of the payments on savings accounts plus earnings credited thereto less lawful deductions therefrom.

**12 C.F.R. § 541.4 (1976 ed.):**

§ 541.4 Savings Account.

The term "savings account" means the monetary interest of the holder thereof in the capital of a Federal mutual association and consists of the withdrawal value of such interest.

**Footnote 4 From "Reply Brief For The United States In Support Of Its Motion For Summary Judgment And Brief In Opposition To Plaintiff's Motion For Summary Judgment" in *Capital Savings & Loan Association v. United States*, 607 F.2d 970 (Ct. Cl. 1979):**

Taxpayer's suggestion (Br. 33) that the proper characterization of its merger as a reorganization might differ vis-a-vis Franklin's guaranty stockholders from what that characterization should be from its standpoint is plain nonsense. All aspects of the merger transaction must be evaluated and then the transaction as a whole will or will not qualify as a reorganization. If, as we contend, the equity interest in Franklin (the guaranty stock) was exchanged for the equivalent of debt (Capital savings accounts), then the merger obviously does not qualify as a reorganization at any level or for any purpose.

**INTERNAL REVENUE CODE OF 1954 (26 U.S.C.):**
Sec. 593. RESERVES FOR LOSSES ON LOANS.

* * * * *

(e)(2) AMOUNTS CHARGED TO RESERVE ACCOUNTS AND INCLUDED IN GROSS INCOME. — If any distribution is treated under paragraph (1) as having been made out of the reserves described in subparagraphs (B) and (C) of such paragraph, the amount charged against such reserve shall be the amount which, when reduced by the amount of tax imposed under this chapter and attributable to the inclusion of such amount in gross income, is equal to the amount of such distribution; and the amount so charged against such reserve shall be included in gross income of the taxpayer.

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